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# EFFECT OF INCOME AND INHERITANCE TAXES ON THE DISTRIBUTION OF WEALTH

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## I.

If I understand the statistics aright the federal income tax (for which, including corporations, only 357,598 returns were received last year) is reaching directly less than one half of one per cent of the population. It further appears, from the published statistics, that 1598 persons with incomes exceeding \$100,000 paid approximately \$11,600,000, or over 40 per cent of the aggregate tax collected. In Wisconsin 60,860 persons were assessed this year, representing about 2.6 per cent of the population. Of these, 667 persons having taxable incomes of over \$10,000 (about 3/100 of one per cent of the population) were assessed for 48 per cent of the total tax. The income tax is still, therefore, as in the days of John Stuart Mill, a rich man's tax. It is drawn predominantly from the rich and in that sense it plainly equalizes the distribution of wealth. Though I have seen no similar statistics relating to inheritance taxes, it is almost certain that the inheritance tax works in the same general way. Both taxes draw far more from the rich than from the poor and plainly operate to equalize wealth in the first instance. May they be expected to do so in the long run? Are their direct effects (shall we say "advantages") counterbalanced by indirect and less obvious consequences? May they profitably be used frankly and affirmatively in behalf of the poor? It is to these larger questions that this paper is particularly addressed.

## II. THE INCOME TAX

1. *Class Taxation.*—No tax which is wasted, that is, which stimulates public extravagance, can exercise a wholesome effect on the distribution of wealth. Such a tax reduces the fund of private capital, which gives employment to labor and cheapens commodities, without starting any compensating activity (except pernicious) on the part of the government. The present federal income tax is a class tax and class taxes breed extravagance. As shown hereafter, the income tax deserves approval from almost every other standpoint, but in this respect the federal income tax

needs courageous correction. Income taxes should not be levied upon the poor—but they should be levied upon all the rich, that is, upon everyone with income exceeding the amount required by the American standard of living. An income tax falling on all the rich, so defined, would be the most potent instrument procurable for inspiring and maintaining an effective interest in the conduct of government. An income tax confined to a fraction of one per cent of the population promotes class conflict, public extravagance, and a needlessly complex method of tax administration. Professor Bullock estimates that it has cost (to private corporations) from 30 to 40 per cent to collect the bond interest withheld at the source under the federal income tax. This and similar administrative complexities would disappear if the tax applied to a larger group of voters.

2. *Reducing Swollen Fortunes.*—Notwithstanding its class restrictions the income tax is a feeble instrument with which in a positive and effective way to reduce swollen incomes or fortunes. To enforce a progressive income tax the coöperation of the taxpayer must be secured. But to secure his coöperation the rates must be fair and reasonable. Moreover, they must impress a majority of the taxpayers as fair and reasonable. The upper limit of enforceable rates is about 10 per cent, and such a rate is not sufficient to reduce swollen fortunes. If swollen fortunes are bad, they should be attacked directly and the cause removed. To let them accumulate and then tax them 10 per cent smacks of hypocrisy, and the attempt to make the income tax do the work of social reform is apt to spoil the income tax. Its virtues are fiscal. It is at its best as a substitute for taxes which exercise a positively deleterious effect upon the distribution of wealth.

3. *As a Substitute for Personal Property Taxes, Particularly on Business Enterprises.*—The income tax of England and America is largely a business tax. In the writer's opinion the income tax could perform its best service as a substitute for the personal property tax as applied to business enterprise. The loss in modern business is enormous, the necessary hazards are great, and a strikingly large proportion of concerns in some lines (for example, water powers, development companies, and the like) constantly totter on the brink of bankruptcy. To all such marginal enterprises the property tax is remorseless. It falls on property as much whether it is productive or unproductive, whether it is owned free or heavily encumbered, whether it is part of a praiseworthy

but desperate new business venture or part of the salvage of a dying concern. The property tax discourages experiment, penalizes industrial pioneering, retards production, reduces supply, and increases prices. In short, it is partly shifted to consumers, reduces the amount of wealth to be divided and adversely affects the distribution of what is produced. In comparison the income tax wrests little or nothing from the new, the experimental, or the unfortunate business enterprise; it helps not only the small business man, but large concerns in new and hazardous undertakings. It helps—or abstains from burdening—every business enterprise in a bad year.

4. *Does it Drive Away the Successful Business?*—The income tax falls heavily on successful business concerns. Will it not drive the successful away, leaving only the weaklings? I have not been able to discover any such tendency in Wisconsin, even in the case of an isolated and exclusive state tax. With a general or inclusive income tax such effects would be entirely negligible. Many large industries are dependent upon land or definitely localized natural conditions and such enterprises must locate and stay at particular places. Others are held fairly fixed at particular places by definite markets or distributing points, or localized labor supply. Most important of all, successful business men acquiesce in the equity of progressive income taxation. What they dread is not the loss of a few dollars in taxes, but an atmosphere of suspicion and the absence of appreciation of the social service rendered by high-class enterprise, honestly conducted. Income taxes devised in a spirit of equity, reasonable in rate, and tactfully administered, drive no enterprise away worth keeping.

The knowledge that income taxes exist, and that the state will take a share of the gains resulting from exertion and investment exercises, over long periods, some repressive effect on the intensity of labor and the supply of capital. This, however, impresses me as so trivial as to be negligible, particularly when the countervailing influence of governmental expenditures is taken into account.

5. *The Income Tax and Government Ownership.*—The property tax puts the state in the position of a preferred creditor, and a harsh one. Its dues must be paid by the business man in the development period of the business, before profits are earned, and later whether profits are earned or not. The income tax, however, presents the state in the attitude of a partner or profit sharer. The first attitude is not wholly indefensible, nor alto-

gether unfortunate. But with respect to business enterprise it needs to be softened by increasing emphasis upon ability to pay. There is a growing feeling among the operators and owners of public utilities that government ownership and operation are inevitable. This feeling or movement is measurably stimulated by the rigors of the property tax. The railroads of this country, for instance, are at present paying over 16 per cent of their net earnings in taxes, and in some states the proportion exceeds 20 per cent. If our tax system gave greater scope to the net income principle, it would materially enhance the chances of private ownership and operation. The income tax works for the retention of private management; it makes the state, not a preferred creditor, and not the sole owner, but a full fledged and sympathetic partner in private industry.

### III. THE FACTORS OF PRODUCTION

1. *Rent and the Landlord.*—The income tax takes a smaller share of rent and is easier on the landlord than the property tax, because unproductive land does not pay an income tax, because the property tax rests upon present value of anticipated rents or earnings, much of which never materializes, and because the revenue from the income tax tends in a measure to reduce the rate of property taxation. Moreover, the largest landlord class in America—the farmers—escape the income tax by reason of the exemptions. In Wisconsin, with exemptions which average \$1228, less than 5 per cent of the farmers were assessed for income tax and the tax on this class averages only \$7.66. Where the income tax reduces the property tax, or prevents increase in its rate, real estate investors are *pro tanto* beneficiaries of the income tax.

2. *Labor and Wages.*—Less than one half of one per cent of the laborers of Wisconsin were assessed for income tax in 1914, and the tax upon those assessed averaged only \$2.91. The laborer, therefore, is less adversely affected by the income tax than by the property tax or by customs and internal revenue duties. Where, as in Wisconsin, the income tax is introduced as a substitute for the taxes on household furniture and allied forms of personal property, the income tax may positively benefit the laborer. With professional and salaried men, however, the reverse is true. Speaking generally, they are called upon to make a substantial contribution under the income tax, whereas they are often exempt, or practically so, under the property tax. In Wisconsin

more than 50 per cent of the lawyers pay income taxes, averaging about \$60 each. Probably a majority of the physicians and surgeons, public officials, and members of the miscellaneous professions pay substantial income taxes.

3. *Capital and Interest*.—In Wisconsin the heaviest contributors are money lenders, retired business men, and the investing classes generally. The average income tax in this class in Wisconsin exceeds \$100. Such classes usually escape or shift the burden to the borrower under the property tax, but this cannot be done under an income tax if properly framed and applied. In general the income tax imposes a comparatively large burden upon interest.

4. *Enterprise and Wages*.—In Wisconsin the heaviest aggregate contribution comes from merchants and manufacturers, particularly the latter. The income tax does not reduce the share taken from entrepreneurs, but it redistributes and readjusts it, sparing the small business man and the marginal enterprises. In general the income tax actually accomplishes what it is designed to do, that is, secure a large contribution from investors, successful professional or salaried men, and from business concerns which have reached the dividend-paying stage.

#### IV. SAVING, THRIFT, AND THE REDUCTION OF CAPITAL

1. *The Problem*.—Nearly all taxes are paid from income. But income in turn is divided between "productive" and "unproductive" uses; it is consumed or reinvested, and the form of the tax exercises an important influence on the amount which will be reinvested. The rich, it is widely believed, save a larger proportion of their incomes than the poor, and the income tax is predominantly a tax on the rich and well-to-do. Will it not, therefore, cut heavily into the wealth set aside for future production and so imperil the capital fund of the nation?

2. *Saving and Thrift*.—A man balances or equilibrates the various items of his budget until the marginal satisfaction is the same in each department. If, now, a typical taxpayer has his income reduced by the imposition of a tax, it seems reasonable to conclude that there will be a reduction in the general level of expenditure, and that this will affect all lines of expenditures. His savings will be diminished but his harmful and unnecessary consumption will also be diminished. It is not impossible—*a priori* it is even probable—that the reduction in saving will largely de-

pend upon the proportion of savings to unnecessary expenditures.

If the rich taxpayer uses 20 per cent of his income for necessities, 60 per cent for conveniences, luxuries, and vices, and 20 per cent for savings, then it seems to me likely in the long run that any tax will come one fourth from savings and three fourths from expenditures for conveniences, luxuries, and vices. At any rate I can think of no more reasonable hypothesis.

If the income tax is introduced as a substitute for other taxes weighing more heavily on the poor, it seems inevitable in the long run that a share of this exemption will go to swell the savings of the poor. Suppose, for instance, that a typical taxpayer who is so relieved has been spending 80 per cent for necessities, 15 per cent for conveniences, luxuries, and vices, and 5 per cent for savings. Such a taxpayer in the long run may reasonably be expected to use any increase in income one fourth for savings and three fourths for additional conveniences, luxuries, and vices. Other things being equal, it is the quantitative relation between saving and unnecessary expenditure which counts. If the rich save 20 per cent of their incomes and spend 60 per cent for unnecessaries, then the ratio of saving to the elastic part of the whole income is the same as in the case of the poor, who spend 15 per cent of their incomes for unnecessaries and save 5 per cent. *A priori* a strong case could be made for believing that the relief to the poor swells the capital fund as much as the draft upon the rich reduces it, or at least that the former effect is more nearly compensatory than has been supposed. In this connection three things must be remembered: The very poor do not pay direct taxes. Increased taxation of the rich, therefore, frequently relieves a middle class of relatively thrifty habits, who do a large amount of saving. Secondly, the relinquished saving of one very rich man makes possible an additional saving on the part of hundreds, perhaps thousands, of poor men and women. From the psychological and moral aspect the wider encouragement to the poor more than counterbalances the more restricted damage to the rich. Finally, the effect of the public expenditures on increasing the demand for labor and improving the status of the poor, must be taken into account.

3. *Intra-Business Saving.*—A large part of the annual harvest of thrift, perhaps the largest part, consists of profits earned by business concerns and turned immediately back into the business or reinvested in related kinds of productive activity. The income

tax reduces this variety of saving. But if it is introduced as a substitute for more regressive forms of business taxation, it is probable that the new savings made possible by the tax will be quite as large as the reduction of old savings effected. *The Wisconsin statistics, for instance, indicate that large corporations are distributing a larger proportion of their earnings to stockholders than are the smaller corporations.* We must also take into account the negative stimulus given by the income tax to commercial experimentation, industrial frontiering, small business, and new enterprises in general.

#### V. THE INHERITANCE TAX

1. *General.*—In Europe the inheritance tax yields enormous revenue and in this country its use is rapidly spreading. It is now on the statute books of over forty states and the revenue increased from about \$10,000,000 in 1908 to \$26,470,964 in 1913. The rates are low in this country, averaging probably less than 3 per cent, even on the largest estates with more than an average share passing to distant relatives. The tax is almost certain to expand rapidly. It does not burden the poor; it is not shifted; it does not drive out marginal producers; it does not destroy business; it does not repress industry or thrift.

2. *Does it impair the capital fund?*—The most formidable charge against it is that it trenches on capital or is paid out of the fund of social savings. Most other taxes are paid out of income, only part of which would be saved or reinvested. In consequence such taxes are drawn in part only from savings. When the executor of an estate, however, sells land or securities to pay an inheritance tax, they will be purchased by men with money seeking investment. In this way the state takes part of the savings of society, and on first sight the whole tax appears to come from social income set aside for reinvestment. It is not true, however, that the whole tax is drawn from social savings destined to nourish and extend productive functions. Had the inheritance tax not been imposed, part of the tax, perhaps a large part, would have been wasted or spent for unnecessaries by the heirs and beneficiaries. What is principal or corpus to the estate is "fortuitous" income to the distributees of the estate, and like other income will be only in part reinvested or saved.

3. *"Public Capitalization of the Income Tax."*—It is probably true, however, that a larger part of inheritance income is saved

than of the ordinary income, and consequently that the inheritance tax does trench more heavily on capital than many other taxes. The American inheritance tax is now so light, however, and there is so much room for harmless expansion, that this characteristic of the tax gives no ground for immediate anxiety. If it ever creates a real danger, the danger may be met by using the proceeds of the inheritance tax to pay off public debts—as suggested by Mill—or to create a public investment fund—as suggested by Professor Alvin S. Johnson,<sup>1</sup> or to do both. Wisconsin has a fund amounting to about \$7,000,000, which is loaned to the minor political subdivisions of the state. Interest and principal are automatically extinguished by annual payments collected along with the ordinary state and county taxes. School districts, small towns and cities, which might otherwise find it expensive and troublesome to borrow at fair rates, find in the state a fair and ready lender; but most important of all, the principal of the debt is unfailingly and automatically extinguished.

4. *As a Reducer of Swollen Fortunes.*—Can the inheritance tax, at highly progressive rates, be used to break up large fortunes? I think not. Legally speaking, the federal government can use this measure only as a tax, that is, the rates (particularly if progressive) must be reasonable judged by tax standards. The states, on the other hand, are held in check by the fact that Rhode Island and a half dozen other jurisdictions do not use the inheritance tax. If the legislatures of other states enacted tax laws with rates rising to 25 or 30 per cent on large bequests, the rich would flee to Newport and other havens of refuge. A few states like Rhode Island could, and probably would, coerce the rest to adopt a moderate policy of inheritance taxation. Inheritance tax rates are now too low in this country on large inheritances. They should be increased. But time and experience will probably prove that 10 or 12 per cent is the highest average rate, even on very large fortunes, which can be successfully imposed in any future period with which we need concern ourselves at this time.

5. *The Present Danger.*—The natural development of the inheritance tax is now being prevented by multiple taxation upon securities. Most of the harm that radical rates could do is being done, although corresponding revenues are not being derived. Some states tax securities at the domicile of the decedent, some in the state where the corporation is incorporated, some where the

<sup>1</sup> *Journal of Political Economy*, February, 1914.

property represented by the securities is situated, some where the trust company in which the securities are deposited is located, and at least one (Minnesota) at the location of the debtor (in the case of municipal bonds). Some states—including Wisconsin—use two or more bases in the same law, for example, taxing stock in foreign corporations when owned by a resident decedent and stock in domestic corporations when owned by a foreign decedent. Sectional differences of treatment are developing, the eastern states tending towards the residence and the western states toward the situs principle. Meanwhile the richer (prospective) taxpayers, encouraged by the unfairness of state legislation, devise means of evasion. This situation must be remedied by a federal constitutional amendment or by joint state agreement before the real possibilities of the inheritance tax can be fully realized.

6. *Revenue and Reform.*—In the case of the inheritance tax, it is not necessary to project the path of evolution far into the future in order to deal wisely with the present problem. The more we talk about 50 per cent inheritance taxes, the less real chance we have of securing the 10 or 12 per cent tax which we might wisely and safely have at once. In general it is unwise to mix revenue and reform. The monopoly price which yields the greatest net return to the monopolist is not the price which yields the largest consumers' surplus. By parity of reasoning, the tax which yields the largest net revenue is not that which represses most the evil that incidentally and collaterally it is expected to ameliorate. Mr. Carnegie would banish the income tax and found his revenue system on an inheritance tax heavy enough to shatter large fortunes. But the more reform his inheritance tax accomplished, the less revenue it would yield. The inheritance tax which he lauds would consume itself in time, and there would emerge the income tax (or something worse) which he rejects.

Excessive inheritance taxes would almost certainly be accompanied by widespread evasion. Evasion can be prevented just so long as men feel it cheaper to employ the state to superintend the distribution of their property after death than to employ private agencies. If the state ever gets to charging 50 per cent, say, for this service, it would pay rich men to employ private agents—trustworthy Rothschilds and similar honest usurers—to superintend the distribution of their property after death. This may seem strange, but the condition under which the state took 50 per cent of a fortune after the death of its owner, would also be strange.

If swollen fortunes are evil, let us not beguile our common sense by indirection. Let us go after them with something better than a lath painted to look like iron.

## VI. CONCLUSIONS

Carefully formulated and efficiently administered income and inheritance taxes do equalize the distribution of wealth and do not, in an appreciable degree, set into motion any subtle, subterranean, or remote economic forces of an objectionable kind, such as the professional economist so dearly and so properly loves to analyze and evaluate. Both are better taxes than instruments of social reform. Their virtues are chiefly fiscal and so far as the distribution of wealth is concerned, negative: their greatest merit is that they can be made to yield a large revenue without adversely affecting the distribution of wealth. As a substitute for certain customs, internal revenue, personal property and gross receipt taxes, both could be wisely and widely extended at the present time. Whether they could be wisely extended as additional taxes depends altogether upon the efficiency of government and the use to be made of the new revenues which they would yield. Here, in the field of public expenditure, is the crucial test of each proposed new tax. For a wasteful and inefficient government no new tax is a good tax. Such a government should be forced by the very pressure and desire for new public service, to eliminate waste and ring out the old as it rings in the new—without enlarging the budget. The very best source of revenue is scientific saving.

With governmental waste eliminated so far as humanly possible, the ultimate problem expresses itself as a contest between public and private enterprise, a comparison between the marginal activities of government and private business. The captains of private industry have given us in the last few years the wireless telegraph, the automobile, Rockefeller Research, and the New Haven scandal. The statesmen have brought us the Panama canal, the reserve bank, the parcel post, and the European war. Which serves most, statesman or industrial captain? Towards the great stream of income and particularly towards the part diverted for future production, both statesman and industrial captain stretch eager hands. Let him have it who can use it best. Neither, in America, may ask with divine right. Neither is sacred—or both are sacred. Private and public: I recognize no hostility and no essential difference. Both are parts of one great social unit.

The public institution must be invested with the initiative and efficiency which mark private business at its best. The private institution must acquire the spirit of social service which marks government at its best. On these terms let the tax gatherers, public and private, compete. The government may have its income and inheritance taxes; the railroads may have their 5 per cent advance in rates—if they will but serve. And let the victory rest with him who serves most.